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CHARLES ELMORE C

IN THE

Supreme Court of the United States

October Term, 1950.
No. 319

EM. H. METTLER & SONS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit, entered in the above entitled case on May 12, 1950, affirming the decision of the Tax Court of the United States [R. 81], which sustained the determination by respondent against petitioner corporation of deficiencies of $5,862.58 in income tax and $84,255.86 in excess profits tax for the calendar year 1942.

Opinions Below.

The memorandum opinion of the Tax Court of the United States [R. 61] is unreported. The *Per Curiam* Opinion of the Court of Appeals for the Ninth Circuit [R. 478] is reported in 181 F. 2d 848.

Jurisdiction.

The judgment of the Court below was entered on May 12, 1950. [R. 479.] On June 10, 1950, petitioner timely filed its petition for rehearing in the Court below. [R. 480.] The petition for rehearing was denied by order entered June 22, 1950. [R. 480.] The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254(1).

Question Presented.

May the Tax Court of the United States disregard and reject competent evidence introduced by a taxpayer petitioner which fully supports the reasonableness of corporate salary deductions claimed under Sec. 23(a)(1)(A), I. R. C., in a proceeding in which the reasonableness of salaries was the sole issue, where the Commissioner offered no evidence to rebut petitioner's proof and the record contains no evidence whatever supporting the Commissioner's determinations that the salaries were excessive?

Statutes and Regulations Involved.

These are set forth in the Appendix, *infra*.

Statement.

The taxpayer was incorporated in California on December 22, 1941, with its principal office at Shafter, in Kern County. [R. 61-62.] As of January 1, 1942, it took over all the business and assets owned by Em. H. Mettler and his wife, Pauline Mettler, in exchange for the issuance to them of 3,264 shares of its stock, having a total par value of $326,400 [R. 62], equal to the value of the assets so transferred. [R. 65.] Mettler and his wife were the sole stockholders of petitioner corporation until June 25, 1942. [R. 65.]

In 1942, petitioner was the only grower of *foundation* potato seed* in California. [R. 99, 153, 154.] It also developed, produced, harvested, packed, shipped and marketed potatoes [R. 62] and other vegetables [R. 342] for ordinary commercial use.

During that year, its operations covered about 1,800 acres over a distance of 158 miles, and comprised 14 ranches in and about Shafter, Lerdo and Edison in Kern County and in and about Santa Maria in Santa Barbara County, California. [R. 66, 95.] It operated packing sheds at Shafter, Edison and Santa Maria. Each of the three packing sheds had adjacent railroad loading facilities. [R. 238.] Taxpayer had its own maintenance shops and yards where it stored, serviced, repaired, altered and built necessary equipment and made parts therefor. [R. 378, 389-390.]

It also had a research laboratory at Santa Maria, better equipped than that maintained by the University of California. [R. 67, 235, 325-326.] It had probably "the best library on the subject of potato diseases and everything which has to do with the potato composition or analysis, * * *, any place in the United States." [R. 326.]

There was no organization in California in 1942 that was comparable to petitioner. [R. 161.]

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*Foundation seed is the highest form of certification obtainable under Title 3 of the California Administrative Code pertaining to agriculture. Foundation seed is planted and from it is produced *commercial* seed. The harvest from *commercial* seed, when planted, is the crop of commercial potatoes which are sold in the open market for human consumption. [R. 99.]

The scope of the duties of its five key-employees, the reasonableness of whose salaries was questioned by respondent, was as follows: Em. H. Mettler had supervision of crop production. Orvin Mettler had supervision of the packing, shipping and sales (including seed sales), and immediate supervision of production at Shafter. Dan E. Weitz had supervision of petitioner's equipment and immediate supervision of production at Lerdo. Raymond A. Mettler had charge of production at Edison and Stephen J. Fairchild had charge of production and research at Santa Maria. [R. 63-64, 301.] Orvin and Raymond Mettler are sons of Em. H. Mettler; Dan E. Weitz and Stephen J. Fairchild are his sons-in-law. [R. 65.]

These five employees were each working for petitioner under a contingent salary formula of one-sixth of its net income, *under agreements made late in 1941.*[1] [R. 261, 338-339, 384.] This one-sixth percentage formula had been adopted by petitioner's predecessor (Em. H. Mettler, doing business as sole-proprietor) in 1933, and had been used consistently[2] each year by him since then, until tax-

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[1]The agreements made by Orvin and Raymond Mettler, Fairchild and Weitz *before January 1, 1942,* that they would work for petitioner for one-sixth of its net income to each, was ratified by corporate resolution on March 3, 1942 [R. 64]. Because the employees working on the one-sixth basis had received only $2,511.36 [R. 188] in 1941, they stated that a minimum salary for each should be fixed. Em. H. Mettler, who, with his wife, then owned *all* the outstanding stock of petitioner, insisted that if a minimum salary was fixed a maximum amount should also be fixed. [R. 185, 186 and 261.] The minimum was thereupon fixed at $12,000 per year and the maximum at $35,000 per year. [R. 64.]

[2]Orvin Mettler commenced working for his father in 1932 on a one-tenth or 10% basis. [R. 286.] Dan E. Weitz worked from 1934 to 1937, inclusive, on a 15% basis [R. 68], and Raymond A. Mettler worked on a 10% basis in 1940 and 1941, with a bonus of $400 in the latter year. [R. 68, 260.] Fairchild has worked continuously on a one-sixth or 16 2/3% basis since 1933.

payer commenced operations on January 1, 1942. [R. 286-288; 47, 289-290, 456; 291, 376, 377, 381, 383.]

It should here be noted that the net income of Em. H. Mettler, a sole proprietor, during the base period years (1936 to 1939, both inclusive) has been taken (pursuant to Sec. 740(a)(D) and (h), I. R. C.) as the basis for computing petitioner's excess profits tax for 1942. [R. 19-22.]

In 1938, respondent closely *scrutinized* [R. 36-48] salaries of $36,211.37 each, paid in 1936 to Orvin Mettler and Stephen Fairchild[3] by Em. H. Mettler, on the basis of one-sixth of his net income for that year to each of his two employees who were then working on that basis. The following findings, among others, were made by respondent, acting through his subordinates, on May 6, 1938:

> "With reference to the amounts paid it might be stated that none of the amounts paid and deducted from the current year's profits was for any other year. The amounts were part of the profits for 1936 and were paid in cash as claimed on the return.
>
> "It is said that there have never been but one written agreement between the employes concerned and the taxpayer, and the other 11 agreements are oral only. The understandings were entered into when the business was small, and during lean or prosperous years it has never been changed. Since they had no capital invested in the venture, the earnings can be said to be entirely from personal services.
>
> "Payments to the said employes were as follows:
> "* * * (Schedule of payments)

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[3]Dan E. Weitz, working on a 15% basis, received $32,990.24.

"The only written contract in evidence is the copy herewith shown as exhibit D. This contract was entered into in 1933 and has been adhered to in the settlement in all subsequent years.

"The other 2 shown above have only oral contracts which are on the same percentages, viz—1/6 of the profits. The 2 first mentioned are sons-in-law; each have their particular part to do. Stephen Fairchild is a chemist and does research work in propagating new species and does some office work. He has some 150 new species to his credit. The other two are on the management end of the business and do the traveling from place to place. The operations extend from Stockton to the Imperial Valley. * * *

EXHIBIT D.

(copy)

12/6/33
Shafter, Calif.

"In consideration of the services of Stephen J. Fairchild rendered to me as a bookkeeper, etc., for the fiscal period from December 1, 1933, to December 1, 1934, I agree to give him 1/6 of the net profits earned by me as a result of my farming activities during said period.

/s/ EM. H. METTLER." [R. 40-41, 47.]

In 1942, under the one-sixth percentage formula, each of the five key-employees were paid a maximum salary of $35,000, and petitioner deducted the total of $175,000 in its 1942 income tax return. [R. 63.]

Respondent increased petitioner's 1942 net income and excess-profits net income in the amount of $106,500 by disallowing, as unreasonable, that amount of the total salaries paid, as follows:

Name	Compensation Paid and Deduction Taken	Compensation Determined Reasonable by Respondent	Compensation Disallowed as Deduction
Em. H. Mettler	$ 35,000.00	$20,000.00	$ 15,000.00
S. J. Fairchild	35,000.00	15,000.00	20,000.00
Orvin Mettler	35,000.00	13,500.00	21,500.00
Dan E. Weitz	35,000.00	12,000.00	23,000.00
Raymond A. Mettler	35,000.00	8,000.00	27,000.00
Total	$175,000.00	$68,500.00	$106,500.00

At the trial of redetermination proceedings instituted by petitioner in the Tax Court, petitioner offered *direct* competent evidence that the salaries paid were reasonable. That evidence consisted of the testimony of Henry M. Boyd [R. 408-423], an experienced dealer and distributor of potatoes [R. 408], who also had experience in growing potatoes on a percentage compensation basis [R. 413-414], who testified that the salaries of $35,000 paid to each of the key-employees of petitioner were reasonable and that the one-sixth percentage of net income arrangement was reasonable [R. 415-416]. He supplemented his testimony by stating, *inter alia*, that the Mettler organization had, year after year, always put out a superior product [R. 411], brought about by hard work and continual experimenting [R. 411-412]; that Mettler potatoes were better graded, more mature, and that they brought a premium of 25 cents per sack above the regular good

potatoes [R. 412]; that he could never get enough Mettler potatoes for his trade [R. 422]; that he knew the five key-employees and was familiar with the way they operated; and that the reputation of these men, singly and collectively, in the potato industry, for the work they had done with regard to the potato and particularly with reference to the yield per acre of their crops, was the very highest [R. 413].[4]

Although Orvin Mettler was prevented from testifying as to whether the one-sixth of net income formula was a reasonable method of compensation [R. 199] Em. H. Mettler testified at length [R. 287-295] that this method and rate of compensation was reasonable. Stephen Fairchild testified to the same effect concerning the one-sixth contingent basis, with a minimum salary of $12,000 and a maximum of $35,000 [R. 344-345].

This *direct* evidence of the reasonableness of the salary agreements in question, and of the salaries paid in 1942, was supplemented and corroborated by other competent evidence introduced by petitioner. The successful effects of Em. H. Mettler's incentive and expansion program [R. 286-287, 428], on the business and net profits of petitioner was demonstrated by the following evidence.

Gross sales or farming receipts increased from $606,026.88 in 1942 (a war year) to $2,400,175.42 in 1947 (a non-war year) [R. 66, 447]. Each intervening year showed a steady increase [R. 447].

The total net profit *after salaries, based on the one-sixth formula,* for the first six years of petitioner's corpo-

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[4]In 1942, the average yield per acre of potatoes in Kern County was 202 100-lb. sacks, whereas petitioner produced 249 100-lb. sacks per acre in that year—an increase of almost 25 per cent.

(R. 143, 299.)

rate existence (1942 to 1947, both inclusive), was $848,-622.44 [R. 66, 448]. The average yearly net profit reaped by petitioner for those six years was $141,437.07. Petitioner's original capital investment amounted to $326,-400.00 [R. 35].

During *each* of the first six years of its existence, petitioner corporation received, *after salaries were paid,* an average net profit equal to 43.33 per cent of its original investment of $326,400.00.

To demonstrate further the high value to petitioner in 1942 of the services rendered by the key-employees, the following evidence was introduced by petitioner:

In 1938, Em. H. Mettler's business was practically wiped out as the result of a potato disease called "ring-rot" [R. 104-105, 207]. Since Mettler and his employees attributed this disease to foundation seed which they had procured from Montana [R. 104], Mettler started out to produce his own foundation seed, and also immediately established a laboratory in Santa Maria [R. 105]. The process of eliminating and preventing the recurrence of this disease was very tedious and slow [R. 107-108, 318-325]. The work continued up to 1944[5] [R. 325]. From the time work was commenced on foundation seed until it was developed to a point where it could be used or sold as such, generally five years were required [R. 110]. Obviously, by 1942, the market, lost in 1938, was regained.

As found by the Tax Court, Mettler's "organization devised or adopted and developed methods of combating

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[5]The organization not only eradicated the ring-rot and other diseases, but also developed a species of White Rose potato, called the Calrose, which is immune to blight. [R. 139-140.]

potato diseases and of improving the quality of potatoes. He was considered by some as the best potato grower in California and the demand for Mettler's potatoes in 1940 and thereafter always exceeded the supply. His organization devised machinery and equipment for planting and for handling potatoes in bulk" [R. 67].

Other evidence of petitioner showed at length and in detail that (as summarized by the Tax Court)

> "the five employees had extraordinary duties and performed exceptional services; they had specialized training and outstanding abilities; they devoted unusual time, effort, talent and skill in the planning and execution of petitioner's operations; they achieved a high degree of success; and they held an enviable reputation in the potato industry" [R. 72].

Respondent offered no evidence whatsoever to rebut the showing made by petitioner. In particular, respondent offered no slightest proof to justify the wide differences in allowable salaries for the five employees, for services which were equally valuable to petitioner.

After submission of the cause, the Tax Court did not hold that petitioner had failed to establish a *prima facie* case as to the reasonableness of the salaries paid. Presumably based on its evidentiary findings, it proceeded to make its own ultimate findings as to the salary that was reasonable for each employee, and these respective amounts coincided with respondent's previous determinations [R. 69, 63].

The Court of Appeals for the Ninth Circuit affirmed the decision of the Tax Court, its opinion consisting only of the words: "The decision of the Tax Court is affirmed" [R. 479].

Specification of Errors to Be Urged.

The Court of Appeals for the Ninth Circuit erred:

1. In failing to hold and decide that the Tax Court of the United States may not disregard and reject competent evidence introduced by a taxpayer petitioner which fully supports the reasonableness of corporate salary deductions claimed under Section 23(a)(1)(A), I. R. C., in a proceeding in which the reasonableness of salaries was the sole issue, where respondent Commissioner offered no evidence to rebut petitioner's proof and the record contains no evidence whatsoever supporting the Commissioner's determinations that the salaries were excessive.

2. In failing to hold and decide that the Tax Court clearly erred in not finding that the compensation payments and contingent percentage formula were fair and reasonable under the undisputed facts.

3. In failing to hold and decide that the ultimate findings and decision of the Tax Court, as to reasonable compensation, are not supported by its evidentiary findings or by any evidence in the record.

Reasons for Granting the Writ.

1. The decision of the Court of Appeals for the Ninth Circuit herein conflicts with the decision of the Court of Appeals for the Fifth Circuit in *J. H. Robinson Truck Lines, Inc. v. Commissioner of Internal Revenue* (entered July 27, 1950) (50-2 U. S. T. C. Par. 9413).

2. The decision likewise conflicts with the decision of the Court of Appeals for the Sixth Circuit in *Mayson Manufacturing Company v. Commissioner of Internal Revenue* (entered November 17, 1949), 178 F. 2d 115.

3. The decision also conflicts with the decision of the Court of Appeals for the Tenth Circuit in *A. & A. Tool & Supply Co. v. Commissioner of Internal Revenue* (entered May 8, 1950), 182 F. 2d 300.

Argument.

The importance of the procedural question involved here to tax administration[6] is best demonstrated by the diametrically opposite conclusions reached in the instant case and in the *Robinson* case, *supra*. In the latter case, the Fifth Circuit in a terse one-page opinion, held categorically that the taxpayer had sustained its burden of proof by introducing the testimony of its president, to whom the questioned salaries were paid, and of two other witnesses, that the salaries were reasonable. It held further that the Tax Court could not reject this evidence, and since the Commissioner offered no evidence, it could not sustain his determinations upon a record containing no evidence whatever supporting them. The following language is most decisive:

> "Here, pointing to the fact that it offered evidence fully and completely supporting the reasonableness of the deductions claimed and the Commissioner offered no evidence whatever, petitioner insists that the finding and judgment of the Tax Court is not only clearly erroneous but is without any support in the evidence and may not stand. We agree.
>
> "To support its claim that the salary it paid Robinson, as president, and the rents it paid him as landlord were reasonable, petitioner introduced the testimony of Robinson and of two other witnesses.
>
> * * * * * * * *
>
> "The Commissioner offered no evidence.
>
> "The Tax Court rejected all of the evidence of all of the witnesses, and upon a record containing no

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[6]Certiorari was granted in *Dobson v. Commissioner of Internal Revenue*, 64 S. Ct. 239, 242, 320 U. S. 489, on this ground.

evidence whatever supporting them, sustained the Commissioner's determinations that the rents and salaries were excessive.

"Upon settled principles, it cannot do this, and in doing so, it erred. *Crude Oil v. Com.,* 161 Fed. (2d) 809 [47-1 U. S. T. C. Par. 9242], and the many cases it cites; *Foran v. Com.,* 165 Fed. (2d) 705 [48-1 U. S. T. C. Par. 9144]; *Grace Bros. v. Com.,* 173 Fed. (2d) 174 [49-1 U. S. T. C., Par. 9181]; *Howell v. Com.,* 162 Fed. (2d) 319 [47-1 U. S. T. C. Par. 928]; *Mayson Mfg. Co. v. Com.,* 178 Fed. (2d) 115 [49-2 U. S. T. C. Par. 9467].

"The judgment of the Tax Court is reversed and the cause is remanded with directions to allow the deductions claimed and redetermine the deficiencies accordingly."

In the present case, where petitioner's direct and indirect uncontradicted evidence as to the reasonableness of the salaries paid, was as strong, if not much stronger, the Ninth Circuit, by its summary decision, without advancing any reasons for affirmance, almost seems to indicate that petitioner, in seeking a review in that Court, was frivolous in contending that it had proved a *prima facie* case in the Tax Court.

Each appellate court had one ultimate question to decide: Did petitioner's evidence constitute *prima facie* proof? They reached opposite conclusions.

To decide that question correctly, one need only to apply an hypothesis: Had the Tax Court sustained the taxpayer's contention as to reasonableness, would taxpayer's evidence have been legally sufficient to support its findings and decision? (*Crude Oil Corp. of America v. Commissioner of Internal Revenue* (10th Cir.), 161 F. 2d

809; *A. & A. Tool & Supply Co. v. Commissioner of Internal Revenue* (10th Cir.), 182 F. 2d 300, 304; *Mayson Manufacturing Co. v. Commissioner of Internal Revenue* (6th Cir.), 178 F. 2d 115, 121.)

How can anyone reasonably say that the mass of strong and convincing evidence introduced by petitioner is *legally insufficient* to support a decision in its favor? For instance, where the evidence showed that Em. H. Mettler had farming experience of over 40 years [R. 285] and, as the Tax Court found "was considered by some as the best potato grower in California" [R. 67], how can it seriously be said that, *as a matter of law,* Em. H. Mettler's services to the corporation were not reasonably worth more than $20,000 for 1942.

The Court of Appeals for the Six Circuit likewise reversed a similar decision of the Tax Court in *Mayson Manufacturing Co. v. Commissioner, supra.* This is a contingent compensation case, similar to the instant one, and the following portion of the Court's conclusion is particularly applicable:

> "This is another case, similar to others referred to herein, where all the testimony before the Tax Court was on behalf of the petitioner. The Commissioner introduced no witness in his behalf. No witness testified that the compensation fixed by the Tax Court for each of the three officers was in fact reasonable compensation for the services rendered. We do not know from the record how those figures were arrived at. On the contrary, petitioner's testimony was that the compensation actually paid was reasonable compensation in each instance. * * * We recognize that in the present case petitioner's evidence on the issue was not from impartial witnesses. But, nevertheless, it was uncontradicted and was not referred to

in the opinion of the Tax Court as being unworthy of belief. Under such circumstances, the failure of the Commissioner to introduce testimony supporting the deductions made by him lends considerable support to our view, gathered from other undisputed facts in the case, that the findings of the Tax Court on the issues involved are clearly erroneous and should be set aside.

The case is remanded to the Tax Court with instructions to set aside the deficiency assessments complained of by the petitioner for the calendar year 1943."

In *A. & A. Tool Supply Co. v. Commissioner, supra,* the Court of Appeals for the Tenth Circuit held that even though the testimony of taxpayer's president, who owned the property in question, was far from satisfactory on the issue of the reasonableness of the rent paid by the taxpayer to her, since it was the only evidence in the record, it was sufficient to overcome the presumption of the correctness of the Commissioner's determination. The ~~Tax~~ Court said:

"* * * With this evidence in the record, we cannot conclude that there was no substantial evidence from which the tax court could make a finding of the reasonable rental value. The presumption that the Commissioner's determination is correct is one of law; it is not evidence and may not be given weight as such. N. Y. Life Ins. Co. v. Gamer, 303 U. S. 161, 171, 58 S. Ct. 500, 82 L. Ed. 726, 114 A. L. R. 1218. When evidence is introduced by the taxpayer sufficient for the Tax Court to base a finding contrary to the determination, the presumption disappears. Crude Oil Corp. of Am. v. Commissioner, 10 Cir., 161 F. 2d 809; Mayson Manufacturing Co. v. Commissioner, 6

> Cir., 178 F. 2d 115, 121. * * * It may not arbitrarily discredit and disregard unimpeached, competent and relevant testimony of a taxpayer which is uncontradicted. There was sufficient evidence as to this item to overcome the presumption of correctness of the Commissioner's determination and the Tax Court should not have disregarded it." (See numerous cases cited in margin.)

There obviously are two schools of thought in cases where the issue of *reasonableness* is involved. One, as exemplified in the findings and opinions of the Tax Court in the *Robinson, Mayson, A. & A. Tool* and instant cases, and the other, as finds expression in the decisions of the Courts of Appeal for the Fifth, Sixth and Tenth Circuits in the three cases named above.

We fully appreciate that this Court might be reluctant to grant certiorari on such conflict between the Tax Court and certain Courts of Appeal. In this case, however, the Ninth Circuit has unqualifiedly endorsed, by summary affirmance, the principle of procedure followed by the Tax Court.

The conflict between the present decision and the decisions of the Fifth, Sixth and Tenth Circuits is irreconcilable.

The question here presented must ultimately be determined by this Court. Much uncertainty in tax administration will be avoided in the future if the question is definitely settled at this time. Justice in administration will then no longer be dependent upon the geographical location of the taxpayer's domicile.

We have not burdened this petition with any extended argument on the merits of petitioner's cause, since we

feel that the conclusion that petitioner proved a *prima facie* case before the Tax Court, is inescapable from what has been said above. We have referred to only a small portion of the evidence which overwhelmingly proved the reasonableness of the salaries paid.

The following, however, should be called to the Court's attention:

No mention is made in the Tax Court's findings or opinion of the fact that the contingent salary agreement in question, was entered into prior to the time (1942) when the services were rendered. At the time when the agreement was made late in 1941, the employees had no means of knowing [R. 345] that they would receive $35,000 for their services in 1942. In fact, the three employees working on the one-sixth basis, received only $2,511.36 [R. 188] in that year (1941). Even the Treasury Regulations (see Appendix) provide that the reasonableness of a contingent salary agreement must be determined as of the time the agreement was made. (Reg. 111, Sec. 29.23 (a)-6(3).)

The Tax Court likewise failed to find that the Mettler organization had four different operations, or four harvest periods during the year in the different localities [R. 196], while a California farmer ordinarily had only one crop of potatoes a year [R. 117]; nor did it make any findings in respect of the evidence of a written offer [Ex. 5, R. 267] of $40,000 per year to Raymond Mettler by one James Tozzi, or of $35,000 per year to Dan E. Weitz [Ex. 11, R. 397], or a finding based on other undisputed evidence (oral) of earlier offers [R. 197-198] of substantially similar guaranteed amounts and percentages.

The Tax Court held that the agreement in question was not an arm's length agreement [R. 74]. There is, in this case, however, in addition to what has already been said, irrefutable proof to the contrary.

The payment of low salaries in 1945 and 1946 constitutes the very best and highest evidence and proof of the good faith of petitioner and its employees, and that salaries were paid under the percentage formula solely as compensation for services actually rendered.

Petitioner's Exhibit 13 [R. 447-448] discloses the following information concerning 1945 and 1946:

	1945	1946
Gross Receipts—Farming	$928,425.33	$1,357,121.31
Less:	* * *	* * *
Total Expenses	919,722.80	1,343,338.30
Net *Operating* Income	$ 8,702.53	$ 13,783.01
Add:		
Rents and Royalties	92.21	
Capital Gain	165,716.22	53,812.15
Total Net Income	$174,510.96	$ 67,595.16

1945.

The net **operating** income of $8,702.53 was arrived at after deducting total salaries of $60,000 for the five key-employees. [See Petitioner's Exhibit 16, R. 456.]

Consequently, the net **operating** income *before such salaries* amounted to $68,702.53.

The *Total Net Income* (after total salaries of $60,000 had been deducted) amounted to $174,510.96.

The *Total Net Income,* before deducting said total salaries of $60,000, was $234,510.96.

If petitioner and its five key-employees were using the percentage formula to siphon off corporate profits in the guise of salaries, then each of them would have taken a maximum salary in 1945 of $35,000, because one-sixth of $234,510.96 amounts to $39,085.16.

Why, therefore, did each take only a minimum salary of $12,000?

They applied the one-sixth percentage formula only to that portion of net income which was *directly* attributable to their services and efforts, *i. e.,* to the Net *Operating* Income (before salaries) of $68,702.53.

Since one-sixth of $68,702.53 is less than $12,000, they each received the agreed minimum salary of $12,000. [R. 456.]

In doing this, they *excluded* from the application of the percentage formula items of income which were *not directly* attributable to their labor and efforts.

Thus, they excluded the "Rents and Royalties" item of $92.21 and the most substantial "Capital Gain" item of $165,716.22.

What more conclusive evidence could there be of good faith on the part of petitioner and its five key-employees, or of a sincere intention and desire to pay just compensation for services actually rendered and only for such services?

1946.

Similarly, in 1946, Net *Operating* Income, *after salaries,* of $13,783.01, plus total salaries of $68,914.90 [see Petitioner's Exhibit 16], amounted to $82,697.91, which sum is the Net *Operating* Income *before salaries.*

Each key-employee received one-sixth of that amount, or $13,782.98 [Ex. 16], as his salary for 1946. [R. 456.]

Here, again, they did not apply the percentage formula to the very substantial "Capital Gain" item of $53,812.15. Had they done so, each employee would have received almost $9,000 in additional compensation, and the total of approximately $45,000, thus paid, would have been fully deductible from petitioner's total net income. The resulting tax saving to petitioner would undoubtedly have exceeded $10,000.

The foregoing demonstrates the good faith of petitioner and its employees, and the inherent justice of their position.

That the salaries paid and the contingent formula under which they were paid were reasonable is amply supported by the following authorities:

North Carolina Equipment Co., 4 T. C. M. 582;

Heyer Products Co., Inc., 6 T. C. M. 1196;

California Vegetable Concentrates, Inc., 10 T. C. M. 1158 (A. 1948-2 C. B. 1);

William S. Gray & Co. v. United States, 35 F. 2d 968 (C. Cls.);

Austin v. United States, 28 F. 2d 677 (C. C. A. 5th);

R. J. M. Co., 5 T. C. M. 491;

John Miller Electric Co., Inc., 4 T. C. M. 1023;

J. D. Van Hooser & Co. v. Glenn, 50 Fed. Supp. 279 (W. D. Ky.);

T. P. Taylor & Co. v. Glenn, 62 Fed. Supp. 495 (W. D. Ky.);

Edgar F. Widin, 4 T. C. M. 328;

Craig Earl, 2 T. C. M. 173, and others.

Conclusion.

We earnestly contend that the Court of Appeals for the Ninth Circuit erred as specified above, and that its error has created a conflict in the decisions of the Courts of Appeal on an important phase of tax administration, which can only be removed by a clarifying decision of this Court upon granting this petition for a writ of certiorari.

For all the reasons set forth above, this petition for a writ of certiorari should be granted.

September 18, 1950.

Respectfully submitted,

GEORGE H. ZEUTZIUS,
A. P. G. STEFFES,
Attorneys for Petitioner.

State of California, County of Los Angeles—ss.

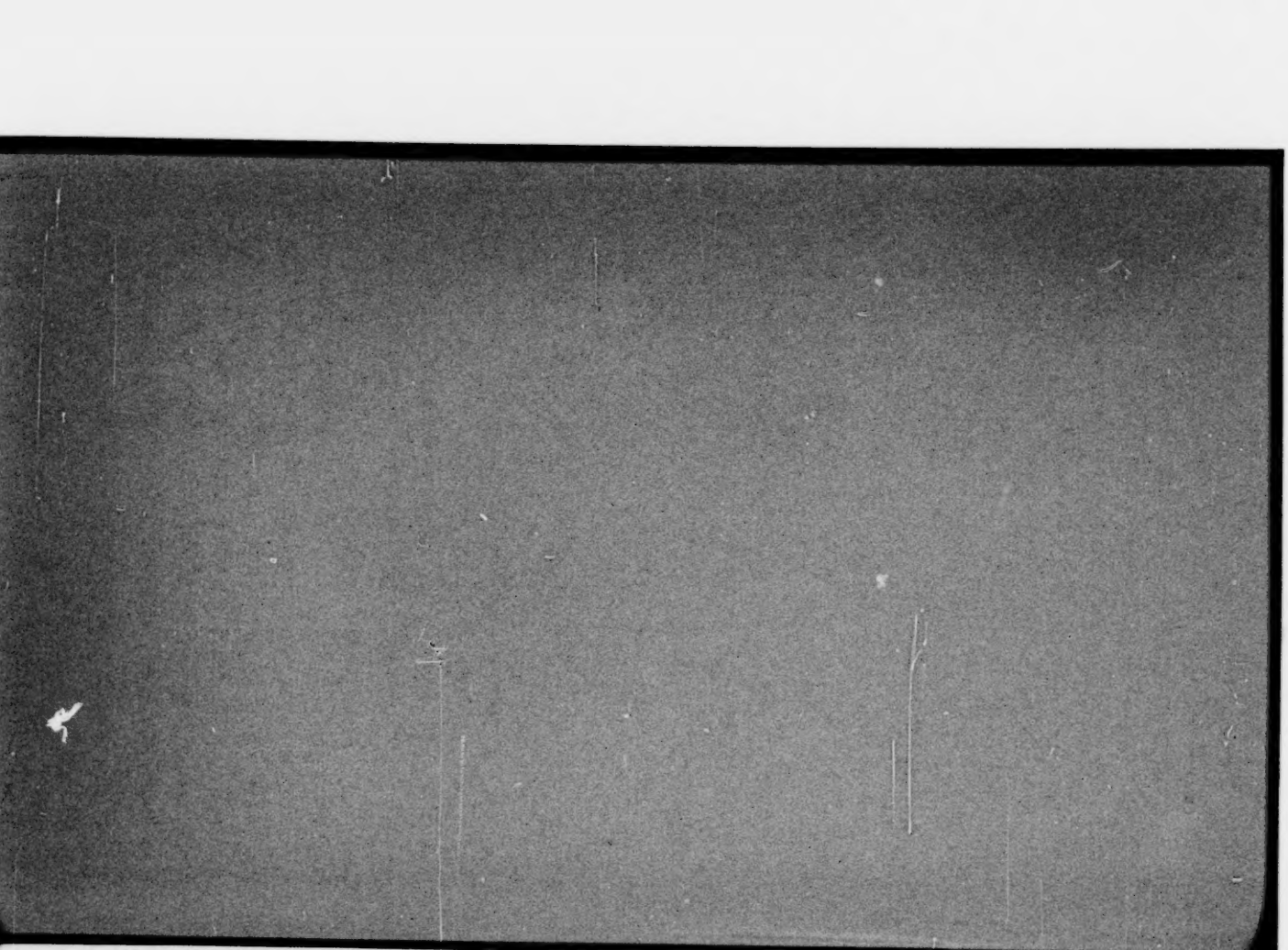
A. P. G. STEFFES and GEORGE H. ZEUTZIUS, being first duly sworn, depose and say, that they are the attorneys for the petitioner named in the foregoing Petition for Writ of Certiorari; that they have read the foregoing Petition for Writ of Certiorari and know the contents thereof; and that the same is true of their own knowledge except as to the matters which are therein stated upon their information or belief, and as to those matters, that they believe them to be true.

A. P. G. STEFFES,
GEORGE H. ZEUTZIUS.

Subscribed and sworn to before me this 18th day of September, 1950.

(Seal) C. S. FREDRICKSEN,
Notary Public in and for the County of Los Angeles, State of California.

My commission expires Oct. 16, 1953.



APPENDIX.

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) Expenses.—

(1) Trade or business expenses.—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

* * * * * * * * *

SEC. 1117. REPORTS AND DECISIONS.

* * * * * * * * *

(b) INCLUSION OF FINDINGS OF FACT OR OPINIONS IN REPORT.—It shall be the duty of the Board and of each division to include in its report upon any proceeding its findings of fact or opinion or memorandum opinion. The Board shall report in writing all its findings of fact, opinions and memorandum opinions.

* * * * * * * * *

SEC. 1141. COURTS OF REVIEW.

(a) JURISDICTION.—The Circuit Courts of Appeals and the United States Court of Appeals for the District of Columbia shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in Section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; * * *

Treasury Regulations 111.

Sec. 29.23(a)-1. Business expenses.—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. * * *

* * * * * * * * *

Sec. 29.23(a)-6. Compensation for personal services.—Among the ordinary and necessary expenses paid, or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (a) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (b) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation.

In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

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In the Supreme Court of the United States

OCTOBER TERM, 1950

No. 319

EM. H. METTLER & SONS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 61–77) are not reported. The *per curiam* opinion of the Court of Appeals (R. 478) is reported at 181 F. 2d 848.

JURISDICTION

The judgment of the Court of Appeals was entered on May 12, 1950. (R. 479.) A petition for rehearing, filed by the taxpayer on June 10, 1950, was denied on June 22, 1950. (R. 480.) The petition for a writ of certiorari was filed on September 20, 1950. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Whether the Tax Court's decision was clearly erroneous in sustaining the Commissioner's determination that the taxpayer's expenditure for compensation for its five principal officers and stockholders was in excess of reasonable compensation and that, to that extent, the taxpayer was not entitled to a deduction under Section 23 (a) (1) (A) of the Internal Revenue Code?

STATUTE AND REGULATIONS INVOLVED

The applicable provisions of the statute and Regulations involved are set forth in the Appendix, *infra,* pp. 17–19.

STATEMENT

The taxpayer, incorporated under the laws of California on December 22, 1941, is engaged in the business of developing, producing, harvesting, packing, shipping, and marketing potatoes for seed and commercial use. It kept its books and filed its income and excess profits tax returns on the accrual and calendar year bases. (R. 61–62.)

Taxpayer acquired, as of January 1, 1942, all of the business and assets, having a stated valuation of $326,400, theretofore owned by Em. H. Mettler and his wife, Pauline Mettler, in exchange for the issuance to them on May 23, 1942 of a certificate for 3,264 shares of its stock. (R. 62, 64–65.) On June 25, 1942, pursuant to sales by Em. H. Mettler and Pauline Mettler, the original certificate was cancelled and stock was issued as

follows: 500 shares to Stephen J. Fairchild and Helen M. Fairchild, 500 shares to Orvin Mettler and Merle F. Mettler, 500 shares to Dan E. Weitz and Gertrude P. Weitz, and 120 shares to Raymond A. Mettler and Thea C. Mettler. Orvin and Raymond Mettler are sons of Em. H. Mettler. Fairchild and Weitz are sons-in-law of Em. H. Mettler. (R. 65.)

Em. H. Mettler, Orvin Mettler, Raymond Mettler, Fairchild, and Weitz constituted taxpayer's board of directors in 1942. (R. 65.) At the first meeting of the board of directors, on January 6, 1942, Em. H. Mettler was elected president, Orvin Mettler, vice-president, and Stephen J. Fairchild, secretary-treasurer. On February 3, 1942, the directors elected Dan E. Weitz assistant secretary, authorized each director to draw on the taxpayer's bank account and outlined the duties of each as follows (R. 63–64):

> Em. H. Mettler shall have general supervision of crop production. Orvin Mettler shall have supervision of the packing, shipping, sales including seed sales, and immediate supervision of the production at Shafter. Dan E. Weitz shall have supervision of the equipment of the corporation and the immediate supervision of production at Lerdo. Raymond A. Mettler shall have immediate charge of the production at Edison. Stephen J. Fairchild shall have charge of production at Santa Maria.

On March 3, 1942, at a regular meeting of the board of directors, held at Shafter, California, the following proceedings were had (R. 64):

> The matter of salaries for the managers of various enterprises of the corporation was brought up. After discussion, it was decided that salaries should be paid along similar lines to those paid by the business prior to incorporation.
>
> Upon motion duly made, seconded, and carried the following resolution was adopted:
>
> Resolved: That salaries for the year 1942 for employees of the corporation listed below shall be to each one-sixth of the net income of the corporation computed without deducting the salaries fixed herein. That regardless of the above, the salary for 1942 for each employee listed herein shall not be less than $12,000.00 nor more than $35,000.00. The employees referred to herein are: Em. H. Mettler, Orvin Mettler, Stephen J. Fairchild, Raymond A. Mettler and Dan E. Weitz.

The testimony indicates that the directors agreed on this maximum salary because the Bureau of Internal Revenue had not disallowed somewhat similar deductions in 1936 when the business was operated as an individual proprietorship. (R. 186, 217–218, 270.) Mettler, prior to the incorporation of the business, had paid the following amounts to his sons and sons-in-law for the years indicated (R. 66):

Year	Orvin Mettler	Fairchild	Weitz	Raymond Mettler
1934	$6,440.40	$6,440.40		
1935	5,380.89	5,380.89	$4,842.80	
1936	36,211.37	36,211.37	32,950.24	
1937	26,257.98	26,257.97	25,054.46	
1938	11,839.50	11,839.50	11,839.50	
1939	4,743.61	4,743.61	4,743.61	
1940	17,116.08	17,116.08	17,116.08	$10,269.64
1941	2,511.36	2,511.36	2,511.36	1,906.81

Mettler's gross income from farming, amounts paid as salaries to these employees, and net farming income during the years 1936–1941 had been (R. 66):

Year	Gross Income	Salaries	Net Income
1936	$420,198.35	$105,412.98	$86,150.49
1937	372,917.21	79,570.40	72,182.28
1938	240,946.78	35,518.50	33,914.88
1939	139,983.61	14,230.83	9,509.32
1940	242,294.77	61,617.88	28,726.88
1941	178,892.71	9,440.89	[1] 2,805.30

[1] Loss.

In his income tax return for 1936, Em. H. Mettler claimed a deduction of $105,412.98 for salaries paid to Orvin Mettler, Fairchild, and Weitz. The Bureau of Internal Revenue notified Mettler of an adjustment based upon an interest credit, but did not disallow any part of the deduction for salaries for 1936. (R. 65.)

Taxpayer's gross farming income in 1942 was $606,026.88 and its net income before deducting the salaries here involved was $219,541.33. (R. 66.) No dividends were paid by the taxpayer

in 1942. (R. 65.) During 1942, taxpayer operated 14 ranches in Kern and Santa Barbara Counties in California, covering about 1,800 acres, of which taxpayer owned about 400 acres. All lands were cultivated and nearly all were irrigated. (R. 66.)

Em. H. Mettler was born November 15, 1887. He began farming in California in 1901, and began farming in Shafter in 1919, producing cotton, potatoes, grapes, tree fruit and alfalfa. He continued farming at Shafter from 1919 to 1932, and in that period acquired other farms. Mettler bought foundation potato seed and raised commercial seed potatoes which he sold. In 1937, his potatoes became diseased with ring-rot and the market was lost. Thereafter, he commenced to develop a foundation seed of his own, and established a laboratory to reduce diseases in his product. His organization devised or adopted and developed methods of combating potato diseases and of improving the quality of potatoes. He was considered by some as the best potato grower in California and the demand for Mettler's potatoes in 1940 and thereafter always exceeded the supply. His organization devised machinery and equipment for planting and for handling potatoes in bulk. (R. 66–67.)

Orvin Mettler was born May 29, 1907. He attended California Polytechnic College for one semester, and then entered his father's employ in

1932. He was associated with his father from 1932 through 1941. In 1942, he entered taxpayer's employ and had general supervision of the ranches at Shafter, as well as of the packing sheds, purchasing, grading, and marketing. (R. 67.)

Stephen J. Fairchild was born November 1, 1902. He attended Occidental College in Los Angeles County for one year, University of California Agricultural School at Davis for two years, and University of California at Berkeley for one year. He received the degree of Bachelor of Science. He married in 1927. He was employed in agricultural work of various kinds, including six years as foreman of a citrus association. On December 1, 1933, he entered the employ of Mettler under a written agreement by Mettler to give him one-sixth of the net profits of Mettler's farming activities for one year and was in Mettler's employ until 1942 when he entered the employ of taxpayer. He did research concerning potatoes while in college and thereafter. While in Mettler's employ he did bookkeeping and office work and participated in Mettler's development of a foundation seed potato. In 1942, he had charge of the packing shed at Santa Maria Ranch. (R. 67–68.)

Dan E. Weitz was born February 25, 1910. He attended Junior College at Bakersfield for one year. He entered Mettler's employ in 1934

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at an hourly wage. In 1935, Mettler agreed to pay him 15 percent of his net profits. In 1938, and until 1941, Mettler paid Weitz one-sixth of his net profits. In 1939, Weitz supervised the Lerdo district and the maintenance shop at Shafter for all Mettler's equipment. Weitz entered taxpayer's employ in 1942, having the same duties. (R. 68.)

Raymond Mettler was born August 29, 1918. He attended Santa Maria Junior College for one year and University of California College of Agriculture at Davis where he graduated in 1939. He then went to work for his father. In 1940 and 1941, Mettler paid Raymond 10 percent of his profits. Raymond had charge of preparing the Edison District land for production. In 1942, Raymond entered the employ of the taxpayer and had charge of the Edison ranch. (R. 68.)

The Commissioner increased taxpayer's 1942 net income and excess profits net income in the amount of $106,500 by disallowing that amount of the total salaries of $175,000 paid by taxpayer during 1942 to its five key employees who also were its chief officers and directors. The following explanation was given by the Commissioner in his deficiency letter (R. 63):

> (a) The deductions for salaries claimed on your income tax return for the calendar year 1942 are disallowed in the amounts stated below, since deductions claimed on your return are held to be unreasonable

under section 23 of the Internal Revenue Code:

Name	Compensation Claimed	Reasonable Compensation	Compensation Disallowed
Em. H. Mettler	$35,000.00	$20,000.00	$15,000.00
S. J. Fairchild	35,000.00	15,000.00	20,000.00
Orvin Mettler	35,000.00	13,500.00	21,500.00
Dan E. Weitz	35,000.00	12,000.00	23,000.00
Raymond Mettler	35,000.00	8,000.00	27,000.00
Total	175,000.00	68,500.00	106,500.00

On the taxpayer's petition to redetermine the Commissioner's deficiency determination, the Tax Court held that the taxpayer had not established that it was entitled to the full deduction or that the Commissioner's deficiency determination was erroneous. (R. 69–77.) The Court of Appeals affirmed *per curiam* (R. 478.)

ARGUMENT

1. The decision below is correct. The question whether the salaries paid by the taxpayer, a family corporation, to its five key employees (who were also the principal officers, directors, and stockholders) exceeded what would be reasonable compensation for the services which they actually rendered, involves an issue which is primarily factual in nature.[1] The Tax Court, after a care-

[1] *Hoffman Radio Corp.* v. *Commissioner*, 177 F. 2d 264 (C. A. 9th); *Locke Mach. Co.* v. *Commissioner*, 168 F. 2d 21 (C. A. 6th), certiorari denied, 335 U. S. 861; *L. & C. Mayers Co.* v. *Commissioner*, 131 F. 2d 309 (C. A. 2d), certiorari denied, 318 U. S. 773; *Clinton Co.* v. *Commissioner*, 159 F. 2d

ful consideration and analysis of all the pertinent matters in a rather voluminous record, concluded that the payment of $35,000 to each exceeded a reasonable allowance for compensation to the extent disallowed in the Commissioner's deficiency notice, and, accordingly, that the payments were not deductible in full as ordinary and necessary business expenses under Section 23 (a) (1) (A), Internal Revenue Code (Appendix, *infra,* p. 17). (R. 61–77.) The Court of Appeals, unpersuaded by the same matters which are still being urged by the taxpayer, and unconvinced that the Tax Court's decision was "clearly erroneous,"[2] affirmed *per curiam.* (R. 478.)

While a detailed discussion of all the underlying evidence and of all the permissive inferences that could be drawn is not now appropriate, reference to only some of the more significant matters is convincing that the Tax Court's resolution of this factual controversy is fully warranted by the record, that its decision is not clearly erroneous, and that the Court of Appeals correctly affirmed.

The payment of large salaries by a family corporation to its principal stockholders requires

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102 (C. A. 7th); *Miller Mfg. Co.* v. *Commissioner*, 149 F. 2d 421 (C. A. 4th); *Crescent Bed Co.* v. *Commissioner*, 133 F. 2d 424 (C. A. 5th).

[2] Section 1141 (a), Internal Revenue Code, as amended by the Act of June 25, 1948, c. 646, 62 Stat. 869; Rule 52 (a), Rules of Civil Procedure; *United States* v. *Yellow Cab Co.*, 338 U. S. 338, 340–342; *United States* v. *Gypsum Co.*, 333 U. S. 364, 394–395.

special scrutiny lest what is claimed as a deductible payment for services rendered may actually be a distribution of profits or other nondeductible outlay. *Crescent Bed Co.* v. *Commissioner,* 133 F. 2d 424 (C. A. 5th). This is particularly true where, as here, the compensation is fixed on a contingent basis. Such compensation, to be reasonable, must be the result of an arm's length bargain which is influenced only by the employer's desire to obtain the services "on fair and advantageous terms." Section 29.23 (a)–6 (2), Treasury Regulations 111 (Appendix, *infra,* pp. 18–19). That this was not the situation in the present case is evident from the fact that, as the Tax Court noted (R. 76–77), each of the stockholding members of the family group was awarded identical compensation notwithstanding the wide disparity in their experience, education, background, and in the duties and responsibilities which they performed for the taxpayer (R. 66–68). Indeed, those who testified on the matter all agreed that, in fixing the amount of the compensation, the board of directors (composed of the same persons who received the salaries) selected a figure which it was thought would be allowable as a tax deduction because a similar amount had not been disallowed in the past. (R. 186, 217–218, 270.) There was, apparently, no attempt to ascertain on what fair and advantageous terms the directors could have secured the

services in question. Further, the absence of any distribution of corporate profits by way of dividends (R. 65), or of any plan for such distribution is persuasive that such a salary arrangement was, in part, a method of siphoning off corporate profits in the guise of compensatory payments.

In this connection, it is relevant to observe, as did the Tax Court (R. 76), that the relatively high income enjoyed by the taxpayer in 1942 was not attributable alone to the services of these individuals but, instead, was largely accounted for by favorable crop conditions and by exceptional price factors arising from war demand and the Government's farm program. Under such circumstances, salaries which are geared to profits do not reflect reasonable compensation for services rendered.

While the record is replete with detailed descriptions of the nature of the taxpayer's business and the duties performed by these employees, there is completely lacking any cogent evidence demonstrating what "would ordinarily be paid for like services by like enterprises under like circumstances." Section 29.23 (a)–6 (3), Treasury Regulations 111 (Appendix, *infra,* p. 19). The absence of such evidence represents a serious defect in the taxpayer's case. *Gem Jewelry Co.* v. *Commissioner,* 165 F. 2d 991 (C. A. 5th), certiorari denied, 334 U. S. 846; *Clinton Co.* v. *Commissioner,* 159 F. 2d 102 (C. A. 7th); *In re Rae's Estate,* 147 F. 2d 204 (C. A. 3d).

The factual minutiae referred to by the taxpayer (Pet. 2–10, 17–20), scarcely need detailed comment, since there is nothing in the record which, by itself, would compel the Tax Court to arrive at an opposite factual conclusion or which, except as indicated below, the taxpayer even relies on as requiring such a result. The taxpayer does, however, contend that there was direct, competent evidence that the salaries paid were reasonable. (Pet. 7, 11, 13.) It attempts to support this assertion by referring (Pet. 7–8) to the opinion testimony of Henry M. Boyd (R. 408–423).[3] It is true that Boyd stated that in his opinion the compensation paid to each of these employees was reasonable. (R. 415–416.) However, the basis on which his opinion was formulated was such that it was entitled to little, if any weight. He was a wholesale distributor of

[3] The taxpayer also asserts that Em. H. Mettler and Stephen Fairchild, two of the employees whose salaries are involved in this case, testified (Pet. 8) "that this method and rate of compensation was reasonable." Reference to the portions of the record relied on by the taxpayer (R. 287–295, 344–345) reveals no direct testimony concerning the reasonableness of the salary payments during the taxable year. Consequently, the Tax Court did not have to decide what weight could have been given to the opinions of these interested witnesses if they had so testified. Their testimony which concerned the reasonableness of salary payments in prior years when the business was conducted by Em. H. Mettler, as an individual, and when salaries and business conditions were different, has no conclusive bearing on the ultimate issue arising under the taxable year in controversy.

potatoes and onions; consequently, he had no direct experience in the taxpayer's business of raising potatoes. He had never had any previous occasion to consider the reasonableness of the salary of an employee of such a corporation (R. 419). His opinion seems to have been based entirely on what he had been told other proprietors had earned (R. 420–421). Further, since these involved earnings of individuals or joint venturors, his reference to earnings failed to eliminate the element of fair return on investments, as distinguished from compensation solely for services, the only relevant consideration in the case of a paid employee. (R. 419–420.) Nor did he explain how employees with such varying experiences and duties could, nevertheless, each be entitled to identical amounts as reasonable compensation for their services. The Tax Court, carefully considering his testimony (R. 75–76), quite properly found his opinion to be (R. 76) "of little probative value."

The taxpayer introduced no compelling proof which would have required the Tax Court to conclude that the salary payments were deductible in full as reasonable compensation for services rendered. Furthermore, when the matters which point the other way are taken into consideration, it seems undeniable that the Tax Court was warranted in refusing to disturb the Commissioner's deficiency determination. Even if the evidence could be

viewed as justifying a contrary decision of the Tax Court, its choice "between two permissible views of the weight of evidence is not 'clearly erroneous'." *United States* v. *Yellow Cab Co.*, 338 U. S. 338, 342.

2. There are no conflicting decisions. *Mayson Mfg. Co.* v. *Commissioner,* 178 F. 2d 115 (C. A. 6th); *A. & A. Tool & Supply Co.* v. *Commissioner,* 182 F. 2d 300 (C. A. 10th); and *J. H. Robinson Truck Lines* v. *Commissioner,* 183 F. 2d 739 (C. A. 5th), relied on by the taxpayer (Pet. 11–16) as creating a conflict, all rest on their own facts. They do not apply principles regarding the "clearly erroneous" test which are opposed to those inherent in the decision below. In the *Robinson Truck Lines* case, *supra,* for example, there was testimony by two disinterested witnesses who were in a position to know that the contested salary payments were the same as those paid for similar services by comparable industries and that the payments were reasonable under the circumstances. The same kind of evidence was offered with respect to certain contested rental payments. No positive testimony or other circumstances contradicted or discredited this evidence. Similarly, in the *Mayson Mfg. Co.* and the *A. & A. Tool Supply Co.* cases, the uncontradicted opinion evidence that the disputed payments were reasonable was given by witnesses

who were in a position to have an informed opinion.

While the soundness of those decisions may be seriously questioned, they are not in conflict with the decision below. The cited cases do not hold that a Tax Court decision is "clearly erroneous" if it refuses to accept with finality the opinion of a witness concerning the reasonableness of an amount claimed as a tax deduction where, as here, the witness has himself demonstrated that he is ignorant of the crucial facts on which knowledge is necessary before a sound opinion can be formulated, and hence that he is not in a position to express an informed opinion. In addition, in the present case, other circumstances disclosed by the record strongly refuted the witness' opinion concerning the crucial fact in issue.

CONCLUSION

The decision below is correct. There is no conflict in decisions and no other reason appears warranting review by this Court. The petition for a writ of certiorari should be denied.

Respectfully submitted.

PHILIP B. PERLMAN,
Solicitor General.
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OCTOBER 1950.

APPENDIX

INTERNAL REVENUE CODE:

SEC. 23 [as amended by Sec. 121 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798]. DEDUCTIONS FROM GROSS INCOME.

> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—
>
> (1) *Trade or Business Expenses.*—
>
> (A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *.
>
> * * * * *

(26 U. S. C. 1946 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

> SEC. 29.23 (a)-6. *Compensation for Personal Services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (*a*) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (*b*) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influ-

enced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

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